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ICPS is optimistic about Ukraine's economic growth over 2005–2007

ICPS economists have upgraded their forecast for Ukraine's economic growth in 2005 to 8%, due to growing consumer demand and a better-than-expected external situation. In 2006, economic growth will slow down to 6% as the situation on external markets deteriorates somewhat, consumption slows down, and investment grows moderately. A victory for pro-presidential forces in the 2006 Verkhovna Rada elections will ensure consistent government policy and will finally provide an opportunity to launch long-expected reforms in the energy and residential services sectors in 2007. ICPS expects investment activity to accelerate and GDP to grow 6.5% in 2007

After a record-breaking 12.1% growth in GDP in 2004, Ukraine's economy slowed down in Q1'05. According to preliminary estimates, GDP grew 5.4% in January–March 2005. The key reason behind this slowdown was a steep decline in industry.

Consumer price inflation accelerated as household incomes grew, and along with them a relatively high propensity to consume and increased spending as people continued to expect their incomes to go higher. In Q1'05, consumer prices climbed 4.4%.

The financial market recovered relatively quickly from the shocks of Q4'04. Since the beginning of 2005, currency inflows have revived and deposits have been growing rapidly. The National Bank has made the hryvnia exchange rate more flexible, using it as a monetary policy instrument. This has led to a slight appreciation of the hryvnia.

The Government has put off long-term objectives

President Viktor Yushchenko started his term in office by fulfilling election promises supported by Ukrainian voters. The Government continued to raise pensions, approved an increase in wages for employees of Budget-financed institutions, and reduced the military draft to 12 months. The National Security Council adopted a decision to withdraw Ukraine's military contingent from Iraq before the end of 2005. Broad voter support for these decisions and Mr. Yushchenko's high personal ratings have ensured a working majority in the Verkhovna Rada that is ready to support most initiatives brought to it by the president and the Government.

The new Government has deliberately begun by resolving short-term tasks and postponing larger-scale and more complicated measures for some time. The Government's current economic efforts are primarily aimed at raising the incomes of the country's poorest, curbing inflation and filling State coffers, including by revisiting previous privatization tenders. This orientation of Government policy towards current needs instead of long-term prospects is the result of: (1) the need to fulfill promises made during the election campaign and the Orange Revolution; (2) the need to make personnel and organizational shuffles in government agencies; and (3) a hangover from the previous Government in the form of many unresolved problems.

Fulfilling current short-term tasks to support the image of a "Government of public trust" among Ukrainians is more effective than unfolding long-term, complicated and unpopular reforms. However, the lack of strategic thinking in formulating social and economic tasks could soon translate into short-sighted policies and, eventually, slower development.

Amendments to the Budget reflect two short-term Government goals: increasing social security and combating corruption. According to ICPS analysts, canceling many territorial and sectoral tax exemptions and lowering customs duty rates will help move businesses out of the shadows and into the official sector. Eventually, this approach will be more effective in attracting investment to Ukraine's economy than tax holidays for preferred investors, as it establishes a level playing field for different investors and manufacturers.

GDP will grow 8% in 2005

ICPS economists have upgraded their economic growth forecast for 2005 to 8% due to increased social benefits and a better-than-expected external situation. Higher household incomes, a relatively high propensity to consume and positive expectations of future income growth will push private consumption among Ukrainians up by 16%.

Imports of goods and services will grow faster than exports for three reasons: price hikes for imported gas and oil, the Government's policy of moving imports out of the shadow and lowering import duty, and the growing buying power of Ukrainian consumers.

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In the latest ***quarterly predictions***, you can read all about:

- The new government's prospects in the March 2006 elections;
- Problems with the Budget's Special Fund;
- The consequences of introducing the second pillar of pension system in 2007;
- The roots of growing consumer prices;
- The dangers of hryvnia appreciation;
- An evaluation of the new Government Program's approach to the farm sector;
- Economic inefficiencies and UkrZaliznytsia's rate policy;
- Does it make sense to cancel exemptions for SEZs and TPDs?
- Problems with current customs policy;
- Slower world economic growth.

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ICPS has downgraded its forecast for the growth of gross fixed assets to 7%. Its economists expect slowdown in investment because of: (1) the lack of mechanisms for revisiting privatization agreements; (2) accelerating inflation; and (3) reduced public capital investment as large social outlays absorb financing from the State Budget.

As a result of amendments to the 2005 State Budget, the share of GDP redistributed through the Budget will be close to one third. Tax pressure on the economy as a whole will grow, in part due to dropping tax exemptions and closing loopholes that allowed tax evasion. In 2005, Consolidated Budget expenditures will grow to 32% of GDP, mainly due to increased social outlays. According to ICPS calculations, real expenditures will be higher than the Government anticipated, as the amended Budget does not take full account of the costs of covering the Pension Fund deficit. The Budget deficit will grow to 4% of GDP.

ICPS economists have upgraded their forecast for 2005 inflation to 16% in light of the steep increase in social outlays. Having shown record-high growth in 2004, producer prices will rise at a more moderate pace in 2005.

The continuing high current account and trade balances will provide an opportunity for the National Bank to replenish gold and forex reserves and allow a moderate appreciation of the hryvnia against the US dollar.

Political stability will make reforms possible in 2006–2007

ICPS expects pro-presidential forces to win the Verkhovna Rada elections in March 2006, as President Viktor Yushchenko will continue to enjoy high ratings among voters. Because there will be no major shuffles, the Government will have a good chance to make consistent decisions, thus, the quality of Ukrainian policies should improve.

The ICPS forecast is for Ukraine's economy to grow 6% in 2006. Slower growth will be primarily due to external factors: slower economic growth among Ukraine's trade partners and lower global prices for the metal products that Ukraine exports. Additional factors holding back growth will be moderate increases in consumption and investment.

In 2007, real gross fixed capital will grow to 10% thanks to continuing political stability, subsiding inflation and lower lending rates. ICPS economists expect 2007 to see the beginning of real reforms, in particular in the energy and residential services sectors, as well as changes in the structure of Ukraine's economy. In line with this forecast, Ukraine's GDP will grow 6.5%.

Pressure on the hryvnia will be weaker because of lower currency inflows. As a result, ICPS expects the nominal hryvnia exchange rate to stabilize in 2007. ■

*ICPS economists have been providing regular forecasts for the economic development of Ukraine since 1997. These forecasts are updated quarterly and published in **quarterly predictions**. If you are interested in receiving this publication on a regular basis, you can subscribe today by contacting Andriy Starynskiy at (380-44) 236-4569 or by e-mail at marketing@icps.kiev.ua.*

For more information about economic forecasts, contact our senior economist, Yevhenia Akhtyrko, at (380-44) 236-1292 or by e-mail at eakhtyrko@icps.kiev.ua.

ICPS to hold business environment conference involving Slovak and Hungarian Finance Ministers

On 16 May, ICPS hosts a conference on improving the business environment. The venue will be attended by Slovakia's Finance Minister Ivan Miklos and Hungary's ex-Finance Minister (1995-1996) Lajos Bokros. Ukraine's Finance Minister Viktor Pynzenyk is also expected to attend. The conference is part of an international project to transfer Visegrad Group economic reform know-how to Ukraine

Today, the Ukrainian Government is facing problems that Central European countries have largely managed to overcome. The experience of these countries could help the Tymoshenko Government avoid typical mistakes of post-soviet countries in implementing market transformations.

On Monday, 16 May 2005, ICPS holds a conference called "How to Improve the Business Environment in Ukraine: Lessons from Central European reforms" in the ICPS conference hall starting at 09:30. The Finance Ministers of Slovakia and Hungary are coming to Ukraine, together with economic experts in Visegrad Group reforms who will present examples of successful experience of economic transformations in the Czech Republic, Hungary, Poland, and Slovakia to their Ukrainian counterparts.

ICPS invites independent specialists, academics, business professionals, and journalists to participate in this important debate. The topics under discussion will include:

- The political economy of reform: How to make reforms happen
- How to get people interested in paying fair taxes
- How to find common ground between business and government in privatization
- How to overcome administrative barriers to doing business

This dialog has been organized as part of the "Transferring Slovak economic reform know-how during pre-election and post-election debates in Ukraine" project, jointly implemented by the International Centre for Policy Studies and the Institute for Economic and Social Reforms (INEKO), Bratislava, Slovakia. The goal of the project is to promote further economic growth and alleviate poverty in Ukraine through improved economic reform policy. For more on this project, visit the ICPS website at *http://www.icps.com.ua/eng/project.html?pid=67*.

The ICPS conference hall is located at vul. Pymonenka 13A, Kyiv, Ukraine (see the map at *http://www.icps.kiev.ua/eng/about/location.html*). Registration starts at 09:00. For participation and media accreditation, contact Irma Pidtepa by telephone at (380-44) 236-4477 or by e-mail at ipidtepa@icps.kiev.ua. Updates on this conference can be found on the ICPS website at *http://www.icps.com.ua/eng/project.html?pid=77*.

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